82-236

No.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUIS STERNBACH & COMPANY,

Petitioner,

- against -

HOWARD SIROTA, FAMILY RESTORATIONS, A Partnership, on behalf of themselves and all others similarly situated,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether the common law doctrine of *respondeat superior* is an implied remedy available in private Causes of Action commenced under Section 10(b) of the Securities Exchange Act of 1934?

2. Whether the element of *scienter* can be established as against an alleged "aider-abettor" of violations of Section 10(b) of the Securities Exchange Act of 1934 on the basis of reckless behavior?

3. Whether an accountant's fraudulent intent can be inferred under Section 10(b) of the Securities Exchange Act of 1934 solely on the basis of claimed inadequate performance of auditing procedures and tests?

THE PARTIES

Petitioner Louis Sternbach & Company ["Sternbach"] was one of the named Defendants in the United States District Court for the Southern District of New York, and was later a Cross-Appellee in the appeal to the Second Circuit Court of Appeals.

Solitron Devices, Inc. ["Solitron"], and certain of its individual officers, including Messrs. Benjamin Friedman, James S. Trager, and James P. Barry, were Defendants in the District Court, and Appellants-Cross-Appellees in the Court of Appeals.[1]

Respondents Howard Sirota and Family Restorations, a Partnership, on behalf of themselves and all others similarly situated, were Plaintiffs in the District Court, and Appellees-Cross-Appellants in the Court of Appeals.

The claims of the class which Plaintiffs Robert J. Berk and Bruce M. Umlas purported to represent were dismissed by the District Court, and that dismissal was affirmed by the Second Circuit Court of Appeals.

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1. Solitron and its individual officers have also filed a Petition for a Writ of Certiorari [No. 81-2367]. The questions presented for review by Solitron and its officers are applicable to, and thus adopted by, Sternbach.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

OPINIONS BELOW

The opinion of the United States Court of Appeals, rendered February 19, 1982, is reported at 673 F.2d 566 (2d Cir. 1982), and is reproduced in the Appendix at A44.[2] The Court of Appeals opinion reversed the District Court's granting of Petitioner's motion for judgment notwithstanding the verdict. The unreported District Court opinion, rendered March 6, 1981, granting Petitioner judgment n.o.v., is reproduced in the Appendix at A1.

The Court of Appeals order denying the Petitions for Rehearing is reproduced in the Appendix at A67. The Court of Appeals order amending its opinion is reproduced in the Appendix at A69.

The Special Interrogatories submitted to and answered affirmatively by the jury as part of its verdict in the District Court are reproduced in the Appendix at A71.

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2. Page references to the Appendix to this Petition are cited as "A ."

JURISDICTION

The judgment of the Court of Appeals was set forth in its opinion rendered February 19, 1982. (A44) A timely Petition for Rehearing was filed by the Petitioner, and denied in an order filed May 13, 1982. (A67) This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

This Petition involves the interpretation and application of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), which provides as follows:

> "§ 78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • •
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

The Petition also involves the interpretation and application of Securities and Exchange Commission Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, which provides as follows:

> "§ 240.10b-5 *Employment of manipulative and deceptive devices.*
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchaser or sale of any security."

STATEMENT OF THE CASE

In 1975, the Respondents commenced this action alleging that Solitron, and certain of its officers, including Messrs. Benjamin Friedman, James S. Trager, and James P. Barry, violated Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 promulgated thereunder. The Petitioner Sternbach, Solitron's independent outside accountants, was alleged to have "aided and abetted" the primary Section 10(b) violations of Solitron and its officers.

Respondents, later certified as a class of purchasers of the shares of common stock of Solitron, alleged that Solitron and its officers, "aided and abetted" by Sternbach, intentionally overstated Solitron's profitability in certain annual Financial Statements. Respondents claimed that Solitron's false and misleading Financials "polluted" the market, and thereby induced Respondents to purchase Solitron's stock at an artificially high price.

A jury returned a verdict in Respondents' favor based upon Special Interrogatories [A71] submitted to them. The jury found Solitron and its officers Friedman, Trager and Barry liable under Section 10(b) for intentionally participating in the publication and dissemination of false and misleading Financial Statements for years 1967, 1968, 1970, and 1972-1974. Sternbach was also found liable as a Section 10(b) "aider-abettor" for years 1967, 1968 and 1970 only, and also found liable for the same years in common law negligence. Sternbach resigned as Solitron's auditor commencing the 1972 fiscal year, and thus could not be held responsible for subsequent periods.

Respondents' proof at trial with respect to Sternbach was primarily premised upon claims that Sternbach had constructive, but not actual, knowledge of Solitron's overstatements of its inventory and sales in the years 1967, 1968 and 1970. Respondents' proof consisted of two reports prepared by the successor accountants Messrs. Price Waterhouse & Company.

The Price Waterhouse reports were prepared at Solitron's behest for use by Solitron in its defense of a claim made by the Eastern Regional Branch of the United States Renegotiation Board. In 1972 the Board had determined that Solitron had earned "excess profits" on its contracts with the federal government during the years 1967 and 1968. Solitron was therefore ordered to disgorge $7,600,000 of "excess profits" to the government. The reports submitted to the Renegotiation Board claimed that Solitron had not been as profitable in the 1967-1970 period as it had originally reported in its Financials and S.E.C. filings, and accordingly, had not earned "excess profits" as claimed by the government.

The Price Waterhouse reports were neither audited nor certified. The conclusions therein were later explicitly rejected by the Renegotiation Board. The Board refused to reconsider its original determination that Solitron had in fact earned "excess profits."[3]

Sternbach's defense at trial was that the Solitron Financials did not contain material misrepresentations, but if there were inaccuracies as alleged by Solitron before the Renegotiation Board, Sternbach was neither actually nor constructively aware of same.

Subsequent to the adverse jury verdict, Sternbach, and Solitron and its officers, moved for judgment notwithstanding the verdict. The motion submitted by Solitron, Friedman, Trager and Barry insofar as it related to 1972-1974 was granted, but denied for

3. Price Waterhouse stated in its report: "We are unable to determine the correctness of the quantities, costs or yield percentages included in the inventory summaries or worksheets for the five fiscal years ended February 28, 1970 or the authenticity of the worksheets and summaries provided us. Accordingly, we express no opinion in the inventory quantities, costs, yield percentages or valuations for the five fiscal years".

years 1967, 1968 and 1970. Sternbach's motion was granted in its entirety on both the Section 10(b) "aider-abettor" and negligence claims, for years 1967, 1968 and 1970.

With respect to the Section 10(b) claim against Sternbach, District Court Judge Charles L. Brieant, Jr. found that there was, "overwhelming uncontroverted evidence in favor of the defendant Sternbach. There was no evidence from which a reasonable juror acting reasonably could have concluded that Sternbach aided and abetted the primary securities law violation with the requisite *scienter*."[4] [A29-30] The common law negligence claim was dismissed as a matter of law, and later withdrawn by the Respondents on the appeal to the Second Circuit.

Thereafter, the Second Circuit reversed the granting of judgment n.o.v. to Sternbach, and affirmed-that part of the District Court decision pertaining to Solitron, Friedman, Trager and Barry.

The Circuit Court decision that concluded that Sternbach was liable as an "aider-abettor" of Solitron's primary Section 10(b) violations based its reasoning on a "combination" of three "facts":

> "Recalling the stringent standard for granting judgment notwithstanding the verdict, we disagree with the court's conclusion that no reasonable juror could have reached a verdict against Sternbach. First, the court's conclusion that Sternbach lacked actual knowledge is inconsistent with the jury's finding, upheld by the court on Defendant's post-trial motion, that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud. Second, evaluation of Cole's credibility, in the face of evidence suggesting he was on notice that the transactions he certified as sales were consignments, was for the jury, not the court. And in light of Sternbach's claim to have performed various costing procedures and tests on Solitron's 1967-70 inventory, the jury might well have concluded that Sternbach knew that its

4. The District Court's instructions to the jury charged that actual intent to defraud—not recklessness—was the appropriate standard of *scienter* for an alleged "aider-abettor" of Section 10(b) violations [A27-28, 57].

> certification of reports overstating inventory was fraudulent. The combination of these facts leads us to the conclusion that there was sufficient evidence for the jury to infer that Sternbach had actual knowledge of fraud in violation of Rule 10b-5. [A59-60]

The Circuit Court's "combination" of "facts" analysis was materially mistaken both in fact[5] and law. The Circuit Court's first so-called "fact", that Sternbach could be held vicariously liable based on co-Petitioner James Trager's "knowledge of the fraud", is erroneous. The other erroneous "fact" recited by the Court was that the jury was permitted to infer that Sternbach possessed an intent to defraud by virtue of its performance of certain audit tests and procedures.

With respect to the first so-called "fact", Respondents never alleged that Sternbach's liability could be vicariously premised on Trager's conduct. That is because although James Trager was employed at Sternbach in 1967, 1968 and early 1969—prior to his employment at Solitron—Trager, contrary to the Court of Appeals opinion, was *not* "a former Sternbach accountant" [A39]. Trager testified that he was a part-time member of Sternbach's lower-echelon staff whose principle function was to count Solitron's inventory and mail confirmations. He was not a certified public accountant, lacked any college or graduate degree, and had completed only two years of college. He described himself as the "lowest fellow on the rung". [A76-79] There was no evidence to the contrary. Accordingly, Trager's primary 10(b) violations could not have been vicariously imputed

5. While it is axiomatic that this Court reviews questions of law, not fact, where, as here, a federal Court of Appeals has predicated its decision upon an egregious and material mistake of fact, as discussed *infra*, this Court can and should correct the error. See, *e.g.*, *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), where the Court reversed the Seventh Circuit's granting of summary judgment to the Plaintiff. In that case, Plaintiff alleged that the Defendant TSC Industries Inc. had participated in the issuance of a false and misleading proxy statement omitting material facts. In reversing, this Court recognized that the question before it was a "mixed question of law and fact" and held that none of the claimed omissions were, "so far as the record reveals, materially misleading as a matter of law" [*Id.*, 426 U.S. at 445-446].

to Sternbach as a matter of law. The common law doctrine of *respondent superior* is not an implied remedy available in private Section 10(b) Causes of Action.

The Court of Appeals further erred in its first so-called "fact" when it stated that Sternbach should be regarded as possessing an intent to defraud because of "the jury's finding . . . that Trager . . . had actual knowledge of the fraud" [A60]. The jury did not so find. Special Interrogatory "3", submitted to and answered affirmatively by the jury as part of its verdict, asked whether Trager "participated in the preparation and dissemination of [the Financial Statements] to the public with actual knowledge of their falsity or misleading nature *or with a reckless disregard of their truth or falsity*" [Emphasis Added][6] [A72-73]. Thus, even assuming *arguendo* that Trager's *scienter* could have been imputed to Sternbach, an actual intent to defraud standard of *scienter* could not have been imputed. The jury found that Trager either intended to defraud, or, acted recklessly. In this circumstance, the Court of Appeals erred when it decided not to reach the question of whether acutal intent to defraud or reckless conduct satisfied the proper standard of *scienter* as respects an alleged Section 10(b) "aider-abettor". [A59] As demonstrated *infra*, the Court of Appeals should have determined that only the standard of actual intent to defraud, not recklessness, satisfied the *scienter* requirement of Section 10(b) "aider-abettor" liability, and in the absence of a jury finding that Trager intended to defraud, Sternbach should not have been found vicariously liable.

The Court of Appeals also erred in the third so-called "fact" of its "combination" analysis when it held that the jury was allowed to have "concluded" that Sternbach possessed an actual intent to

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6. When reviewing a District Court judgment, the Court of Appeals is obliged to synthesize the District Judge's instructions and the jury's special findings so as to support the judgment. The failure to do so "results in a collision with the seventh amendment." *Atlantic & Gulf Stevedores, Inc.* v. *Ellerman Lines, Ltd.*, 369 U.S. 355, 364 (1962). The Seventh Amendment provides that "no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law".

defraud because of "Sternbach's claim to have performed various costing procedures and tests in Solitron's 1967-70 inventory". [A60] An accountant's performance of routine and ordinary auditing tests and procedures cannot, standing alone, permit a jury to infer an intent to defraud.

REASONS FOR GRANTING THE WRIT

I

THE COURT OF APPEALS ERRED WHEN IT HELD THAT THE COMMON LAW DOCTRINE OF *RESPONDEAT SUPERIOR* IS AN IMPLIED REMEDY IN PRIVATE CAUSES OF ACTION COMMENCED UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934.

In holding that the Sternbach partnership was liable under the federal securities law based on the acts of Trager, the Court of Appeals applied and extended the common law doctrine of *respondeat superior* in a manner never envisioned by either Congress or the Courts.[7] The Second Circuit's decision below irreconcilably conflicted with existing judicial authorities and should therefore be reversed insofar as it related to the Petitioner Sternbach.

The Court has never decided the issue of whether the doctrine of *respondeat superior* is an implied private remedy available for imputing Section 10(b) "aiding-abetting" liability. Recent decisions of this Court have severely restricted the availability of implied remedies under the federal securities law.

In *Touche Ross & Co.* v. *Redington*, 442 U.S. 560 (1979), this Court refused to recognize that Section 17(a) of the Securities Exchange Act of 1934 [15 U.S.C. § 78q(a)], which requires broker-dealers and others to prepare and file such records as the Securities and Exchange Commission may prescribe, created a private Cause of Action.

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7. See, generally, Fischel, "Secondary Liability Under Section 10(b) of the Securities Act of 1934," 69 *California Law Review* 80 (1981).

This Court charaterized as "entirely misplaced"[8] arguments that general tort law principles should justify a Section 17(a) implied right of action. Rather, this Court stated that the "central inquiry" is "whether Congress intended to create, either expressly or by implication, a private cause of action."[9] In the absence of statutory language indicating Congressional intent to create a Section 17(a) private remedy, none was implied.[10]

Further reasoning for the *Touche Ross* decision is found in the maxim *expressio unius est exclusio alterius*. The *Touche Ross* Court further reasoned that in view of the fact that Section 17(a) is found amidst other provisions of the Securities Exchange Act which do expressly grant private Causes of Action, the existence of these express remedies dictated against implication.[11] This Court observed that a Section 17(a) implied private remedy would necessarily conflict with the express private remedy of

8. 442 U.S. at 568.

9. *Id.* at 575. In holding that the foremost factor in determining the existence of an implied remedy is Congressional intent, and not the application of tort law, this Court rejected its earlier rationale expressed in *Texas & P.Ry. Co.* v. *Rigsby*, 241 U.S. 33 (1916). In a similar vein, *Touche Ross* also narrowed the holdings of *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), and *Cort* v. *Ash*, 422 U.S. 66 (1975). In *Borak* and *Cort*, this Court held that a private right of action could be inferred to effectuate the remedial intent of a statute even where no Congressional intent to create such a private right could be found.

10. The Plaintiffs in *Touche Ross*, as in the case at bar, alleged that accountants had certified as accurate a false and misleading financial statement. The accounting firm of Touche Ross & Co. was alleged to have certified the false and misleading financial statement of Weiss Securities, Inc., a securities brokerage house registered with the S.E.C. The financial statement, filed with the S.E.C. pursuant to Section 17(a), failed to disclose the alleged scheme of Weis's officers to conceal Weis's deteriorating financial condition. After Weis went into liquidation, and Redington was appointed trustee, the trustee sued Touche Ross on behalf of Weis's customers, alleging violations of Section 17(a). In the absence of statutory language in Section 17(a) that expressly creates a private remedy against accountants for certifying inaccurate financial statements, this Court reversed the Second Circuit's holding that Section 17(a) somehow established such a private remedy.

11. This Court cited its rationale in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 734 (1975): "When Congress wished to provide a damage remedy, it knew how to do so and did so expressly." 442 U.S. at 572. The Court referred to this as the rule of *expressio unius est exclusio alterius*. The expression of one thing is the exclusion of the other.

Section 18(a) [15 U.S.C. § 78r(a)], which creates a private action against persons who make materially misleading statements in reports filed with the S.E.C. The express remedy of Section 18(a) is limited to persons who, in reliance on the statements, purchased or sold securities at a price influenced by the statements. However, the Section 17(a) implied right of action suggested by the Plaintiffs in *Touche Ross* did not contain the allegation that Plaintiffs had relied on Touche Ross's certification when purchasing and selling securities. Hence, this Court concluded:

> "[W]here the principal express civil remedy for misstatements in reports [Section 18] . . . is by its terms limited to purchasers and sellers of securities, we are extremely reluctant to imply a cause of action in § 17(a) that is significantly broader than the remedy that Congress chose to provide." 442 U.S. at 574.

In *Transamerica Mortgage Advisors* v. *Lewis*, 444 U.S. 1 (1979), this Court again declined to imply a private right of action out of an existing federal regulatory statute. This Court adhered to its reasoning in *Touche Ross* when it held, that in the absence of express Congressional intent to create a private action for damages in Section 201 of the Investment Advisers Act of 1940 [15 U.S.C. §§ 80b-1-80b-21], no private action would be implied. As in *Touche Ross*, the *Transamerica* Court based its decision on the *expressio unius* rule[12], the language of the statute, and the absence of legislative history to the contrary.[13]

Touche Ross and *Transamerica* are consistent with the line of this Court's decisions that have narrowly interpreted and applied

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12. With respect to the *expressio* rule, this Court explained that in light of the express remedies of enforcement provided for in Section 206 of the Investment Advisers Act, Congress could not have "absentmindedly forgot to mention an intended private action." 444 U.S. at 15.

13. *Touche Ross* and *Transamerica* are consistent with other recent Supreme Court cases narrowing the availability of implied rights of action. *See, e.g. National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U.S. 453 (1974); *Securities Investor Protection Corp.* v. *Barbour*, 421 U.S. 212 (1975); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S.1 (1977).

Section 10(b). This Court has emphasized that in determining whether a Complaint stated a viable Cause of Action under Section 10(b), it was necessary to "turn first to the language of § 10(b)", for "[t]he starting point in every case involving construction of a statute is the language itself."[14]

In *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), this Court held that an attempt to purchase or sell a "security" did not satisfy the requirement of the explicit language of Section 10(b) that the complained-of activity be "in connection with the purchase or sale of any security."

In *Ernst & Ernst* v. *Hochfelder, supra*, this Court held that evidence of negligent conduct would not suffice to state a Section 10(b) Cause of Action. This Court focused on the language of Section 10(b), which prohibits, "any manipulative or deceptive practice." These words, said this Court, "make unmistakable a Congressional intent to proscribe a type of conduct quite different from negligence."[15] A Section 10(b) Cause of Action, held this Court, required a showing of *scienter*, defined as, "a mental state embracing intent to deceive, manipulate, or defraud."[16] The question of whether reckless conduct can constitute *scienter* was reserved.

This Court's emphasis on the statutory language of Section 10(b) was again evident in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977). This Court refused to recognize an actionable claim under Section 10(b) for alleged breaches of "fiduciary duty" in connection with a corporate merger. This Court held that absent manipulation or deception, Section 10(b) did not reach breaches of "fiduciary duty."

It is apparent, then, that based on recent decisions of this Court, an implied private remedy of *respondeat superior* cannot be found to exist in Section 10(b).

There is no language in Section 10(b) from which one could reasonably imply the *respondeat superior* doctrine. Nor is there any evidence of Congressional intent suggesting such a reading.

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14. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976).
15. *Id.* at 199.
16. *Id.* at 193 n.12.

To the contrary, the *expressio unius* rule suggests that Congress did not intend to confer Section 10(b) with the attributes of vicarious liability. Section 20(a) of the Securities Exchange Act of 1934 [15 U.S.C. § 78t(a)], and Section 15 of the Securities Act of 1933 [15 U.S.C. § 77o] each provide that a "controlling person" may be liable for the securities violations of others. Each provision also has a "good faith" defense. That is, a person is protected from liability if he can prove that he exercised reasonable internal supervision against securities violations. *See, e.g. Zweig* v. *Hearst Corp.*, 521 F.2d 1129, 1134-1135 (9th Cir. 1975), *cert. den.* 423 U.S. 1025 (1975). In light of Sections 20(a) and 15 and the *expressio* rule, Sternbach submits that it is fair to conclude that Congress intended the "controlling person" provisions of the securities law to be the exclusive method of imposing liability on employers.[17]

The Circuit Courts are divided on the question of whether *respondeat superior* is applicable to Section 10(b) and other provisions of the securities law, or, whether the statutory "controlling person" provisions are the exclusive means for imposing vicarious liability. The majority of the Circuit Courts have held

17. *See* Fischel, "Secondary Liability . . .", 69 *California Law Review* at 86-87, where it is noted that in the absence of recognizing the "controlling person" provision as the exclusive method for imputing liability, Plaintiffs can circumvent the "good faith" defense available to "controlling person" Defendants by simply pleading *respondeat superior*, which has no "good faith" defense. This inherent unfairness caused one commentator to remark:

> "[S]pecific requirements of the express liability provisions are essentially nullified if Plaintiffs may sue for the same statutory violation under an implied right of action that is not subject to the barriers contained in the express provisions. Such nullification causes serious disruption of a carefully designed regulatory scheme since Plaintiffs will enjoy procedural or substantive advantages not intended by Congress."

Comment, "Implied Rights of Action in Federal Legislation: Harmonization Within the Statutory Scheme", 1980 *Duke Law Journal* 928, 940.

that the "controlling person" provisions and *respondeat superior* can both be utilized to impose vicarious liability.[18] The Third, Eighth and Ninth Circuits hold otherwise.[19]

The Court of Appeals erred when it held Sternbach vicariously liable based on the acts of Trager, a part-time clerk. Neither Section 20(a) nor *respondent superior* can be fairly utilized to impute Trager's *scienter* to Sternbach. Section 20(a) is inapplicable because no such claim was pleaded by the Respondents. The *respondeat superior* doctrine is inapplicable because based on the rules of statutory construction provided for in *Touche Ross* and *Transamerica*, a *respondeat superior* remedy is not implied in Section 10(b) private Causes of Action.[20]

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18. *See, Marbury Management* v. *Kohn*, 629 F.2d 705 (2d Cir. 1980), *cert. den.* 449 U.S. 1011 (1981); *S.E.C.* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976); *S.E.C.* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *Sennott* v. *Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973); *cert. den.* 414 U.S. 926 (1973); *Richardson* v. *MacArthur*, 451 F.2d 35 (10th Cir. 1971); *Armstrong, Jones & Co.* v. *S.E.C.*, 421 F.2d 359 (6th Cir. 1970), *cert. den.*, 398 U.S. 958 (1970); *Myzel* v. *Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. den.* 390 U.S. 951 (1968).

19. *See, Christoffel* v. *E.F. Hutton & Co.*, 588 F.2d 665 (9th Cir. 1978); *Roches Bros., Inc. (Roches II)* v. *Rhoades*, 527 F.2d 880 (3rd Cir. 1975); *Zweig* v. *Hearst Corp.*, 521 F.2d 1129 (9th Cir. 1975), *cert. den.* 423 U.S. 1025 (1975); *Klapmeier* v. *Telecheck Int'l, Inc.*, 482 F.2d 247 (8th Cir. 1973). The Third Circuit's view on this matter was somewhat modified in *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175 (1981), *cert. den.* ___U.S.___, 102 S.Ct. 1427 (1982). In that case, the Court held that where a "stringent duty to supervise its employees arose" [*id.* at 184], an exception to the exclusive remedy of Section 20(a) would arise. Based on this theory, the Court held the accounting firm of Coopers & Lybrand liable for the Section 10(b) violations of an associate accountant, who worked on substantive tax matters under the direct supervision of four Coopers & Lybrand partners, because Coopers was in a "position in which the investing public would place their trust and confidence in it." [*id.* at 183]. At the same time, the Third Circuit emphasized "that the doctrine of respondeat superior, though applicable in this case, has not been and should not be widely expanded in the area of federal securities regulation" [*id.* at 183]. The Court noted that this Court has not addressed the question [*id.* at 181 n.5]. Compare *Sharp* with the case at bar where the Second Circuit has held an accounting firm liable based on the *scienter* of a part-time clerk who counted inventory.

20. Moreover, even if applicable, it is questionable whether the doctrine should ever be extended so far. The Court of Appeals holding that Sternbach is liable based on the *scienter* of a part-time clerk has extended as limitless the parameters of an accountant's liability under the federal securities law. *Cf. Sharp* v. *Coopers & Lybrand, id.*

II

THE COURT OF APPEALS ERRED WHEN IT DID NOT REACH THE QUESTION OF WHETHER RECKLESS BEHAVIOR CAN SATISFY THE ELEMENT OF *SCIENTER* IN A SECTION 10(b) "AIDING-ABETTING" CLAIM

The Court of Appeals again erred in the first so-called "fact" of its "combination" analysis with respect to a key factual matter. The Court erred when it held:

> "[T]he [district] court's conclusion that Sternbach lacked actual knowledge [of the fraud] is inconsistent with the *jury's finding . . . that Trager—who was employed by Sternbach in 1967, 1968, and early 1969—had actual knowledge of the fraud.*" [Emphasis Added]. [A59-60].

The jury did *not* find that co-Petitioner Trager had "actual knowledge of the fraud" while engaged as a part-time clerk for Sternbach. In Special Interrogatory "3" [A72-73], the jury found that for years ending February 28, 1967 and 1968, the applicable time periods of that Interrogatory during which Trager was employed at Sternbach, Trager:

> ". . . participated in the preparation and dissemination of . . . [the financial statements] . . . to the public with *actual knowledge* of their truth or misleading nature *or* with a *reckless disregard* of their truth or falsity" [Emphasis Added].

Thus, the Court of Appeals erred when it held that the jury found that Trager had "actual knowledge of the fraud," and such actual knowledge should be vicariously imputed to Sternbach. The jury found that either Trager participated with actual knowledge of the fraud or acted recklessly. Assuming *arguendo* that Trager's *scienter* could have been imputed to Sternbach on a *respondeat superior* theory, the intent to defraud standard of *scienter* could not have been imputed to Sternbach because the jury did not indicate whether Trager possessed an intent to defraud the Respondent class members.

In light of the jury's disjunctive finding, that Trager either intended to defraud or acted recklessly, the Court of Appeals wrongly decided "not [to] reach the question whether Sternbach . . . should have been judged under a recklessness standard [of *scienter*]," rather than the District Court's standard of actual intent to defraud [A59]. The Court of Appeals should have adjudged Sternbach under the standard of actual intent, and in the absence of a jury finding that Trager acted with actual intent to defraud, Sternbach should not have been held liable.[21]

This Court has expressly reserved the question of whether actual intent to defraud is the sole means for satisfying the Section 10(b) requirement of *scienter*, or, whether reckless behavior will also suffice. *Aaron* v. *S.E.C.*, 446 U.S. 680, 686 n.5 (1980); *Ernst & Ernst* v. *Hochfolder, supra*, 425 U.S. at 193 n.12.

The Circuit Courts have generally held that reckless behavior will satisfy the element of *scienter* in a primary Section 10(b) Cause of Action.[22]

The Circuit Courts are less settled on the question of whether recklessness will satisfy the *scienter* requirement of Section 10(b) "aiding and abetting" liability.[23]

The Second Circuit has held that reckless conduct can satisfy the *scienter* element of Section 10(b) "aider-abettor" liability only where a Defendant owed a "fiduciary duty" to the Plaintiff. *Edwards & Hanley* v. *Wells Fargo Securities Clearance Corp.*, 602 F.2d 478, 484-485 (2d Cir. 1979), *cert. den.* 444 U.S. 1045

21. In the alternative, and assuming *arguendo* that *respondeat superior* is implied in Section 10(b), this Court can remand this case for a determination of whether Trager, while employed at Sternbach as a part-time clerk in 1967, 1968 and early 1969, actually intended to defraud the Respondent class of Solitron shareholders.

22. *E.g., Healy* v. *Catalyst Recovery, Inc.*, 616 F.2d 641 (3rd Cir. 1980); *Keirnan* v. *Homeland, Inc.*, 611 F.2d 785 (9th Cir. 1980); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *I.I.T.* v. *Cornfeld*, 619 F.2d 909 (2d Cir. 1980); *Sundstrand Corp.* v. *Sun Chem Corp.*, 553 F.2d 1033 (7th Cir. 1977), *cert. den.* 434 U.S. 875 (1977).

23. In *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47-48 (2d Cir. 1978), *cert. den.* 439 U.S. 1039 (1978), a three-prong test for aider-abettor liability was adopted. The test requires proof of (1) fraud by the primary violator; (2) knowledge of the primary fraud, and (3) substantial assistance.

(1980); *Rolf* v. *Blyth, Eastman Dillon & Co., supra*, 570 F.2d at 44. In the case at bar, the Second Circuit refused to decide whether Sternbach owed the Respondents a "fiduciary duty", and whether, accordingly, Sternbach should be adjudged under the recklessness standard [A59]. The Second Circuit did note that three New York Southern District Courts were split on the question of whether accountants should be adjudicated under an actual intent or recklessness standard of *scienter*. [A57-58]. Most recently, in *Decker* v. *Massey-Ferguson, Ltd.*, Slip Opinion dated June 3, 1982 [Docket No. 81-7446], the Second Circuit declined to decide whether corporate directors, alleged to be Section 10(b) "aider-abettors," should be adjudicated under an actual intent or recklessness standard.

Other Circuit Courts have reached conflicting results when defining the *scienter* standard applicable to "aiding-abetting" liability. The Fifth Circuit in *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975), held that differing standards of *scienter* should be applied, dependent on the alleged "aider-abettor's" duty of disclosure to the Plaintiff. As stated by Judge Goldberg of that Court:

> "When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved. Where some special duty of disclosure exists, then liability should be possible with a lesser degree of scienter." [*Id.* at 97].

On the other hand, the Third, Sixth, Seventh and Tenth Circuit Courts have held that only actual intent to defraud, or conduct sufficiently equivalent thereto, will satisfy the *scienter* element.[24]

This Court has reserved the question of whether reckless conduct can constitute "scienter". The Circuit Courts are split on

24. *Edward J. Mawod & Co.* v. *S.E.C.*, 591 F.2d 588, 595-596 (10th Cir. 1979); *Mensen* v. *Consol. Dressed Beef Co., Inc.*, 579 F.2d 793, 799-800 (3rd Cir. 1978), *cert. den.* 439 U.S. 930 (1979); *Landy* v. *Midwestern United Life Ins. Co.*, 259 F.Supp. 673, 680 (N.D. Ind. 1966) (motion to dismiss denied), 286 F.Supp. 702, 708 (N.D. Ind. 1968) (decision on the merits after trial), *aff'd* 417 F.2d 147 (7th Cir. 1969), *cert. den.* 397 U.S. 989 (1970).

the question with respect to "aider-abettor" liability. This Court is requested to grant certiorari to resolve the conflict among the Circuit Court decisions as to the nature of the element of *scienter* sufficient to establish a Section 10(b) "aiding-abetting" claim.

III

THE COURT OF APPEALS ERRED WHEN IT HELD THAT ACCOUNTANTS' PERFORMANCE OF AUDITING PROCEDURES AND TESTS CAN, STANDING ALONE, GIVE RISE TO AN INFERENCE OF FRAUDULENT INTENT UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

In the third so-called "fact" of its "combination" analysis, the Court of Appeals predicated its judgment of liability against Sternbach upon a determination that accountants' performance of various auditing procedures and tests can somehow provide a jury with grounds to infer the accountants' "fraudulent" intent under Section 10(b) of the 1934 Act. The Court of Appeals held as follows:

> "And in light of Sternbach's claims to have performed various costing procedures and tests on Solitron's 1967-1970 inventory, the jury might well have concluded that Sternbach knew that its certification of reports overstating inventory was fraudulent." [A60]

This holding, extending as limitless the parameters of accountants' liability under the federal securities law, is erroneous, and conflicts with holdings of this Court, and the Third and Sixth Circuits.

In *Ernst & Ernst* v. *Hochfelder, supra*, a Section 10(b) action against the accounting firm of Ernst & Ernst was dismissed by this Court in the absence of the accountants' fraudulent intent. This Court defined the requisite showing of fraudulent intent under Section 10(b) as "a mental state embracing intent to deceive, manipulate or defraud." Under this standard, this Court dismissed the Section 10(b) claim against Ernst & Ernst, although, as here, the accounting firm was acknowledged to have

performed various auditing tests and procedures. The Plaintiffs' specific factual claim against Ernst & Ernst was that it had failed to detect management's fraud, which fraud would have been detected had Ernst & Ernst properly audited management's internal accounting controls. Ernst & Ernst defended by claiming that it had conducted its audit in accordance with the "Generally Accepted Auditing Standards" promulgated by the American Institute of Certified Public Accountants, and, in any event, it did not act with *scienter*. This Court dismissed the Section 10(b) claim in the absence of proof that Ernst & Ernst's audit was conducted with fraudulent intent, thereby reversing the Seventh Circuit.

In *McLean* v. *Alexander*, 599 F.2d 1190 (3rd Cir. 1979), accountants were alleged to have violated Section 10(b) in view of their certification of Financial Statements that overstated accounts receivable. Plaintiffs alleged that the accounts receivable included certain "consignment" transactions which were improperly recorded as sales. As in *Ernst & Ernst*, the accounting firm's defense was that it had performed its audit in accordance with "Generally Accepted Auditing Standards," and, in any event, it did not act with *scienter*. In dismissing the Section 10(b) claim, the Court held that the accountants' audit, standing alone, could not sustain a 10(b) claim.[25]

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25. The Court stated: "The [accounting firm's] representation was, then, an expression of opinion based upon generally accepted auditing standards. [The accounting firm of] C&S could be held to have the necessary scienter only if the evidence supports an inference that when it expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion. . . Although the defendants contended these sales had occurred, testimony by agents of L.B. Smith, Robbins, and Southern Laser established to the satisfaction of the Court that the sixteen transactions were in the nature of consignments. There was no evidence that Schiavi, the [accounting firm] partner in charge of the audit, had actual knowledge of the consignment sales. Thus [the accounting firm] could be held to have the requisite scienter only if the investigation it made, and the knowledge it had, give rise to an inference that it 'must have been aware' of the risk that the accounts receivable item was misleading. Upon examination of the evidence bearing on Schiavi's investigation of the four questioned accounts, we conclude that such an inference was not permissible in this case." 599 F.2d at 1198-1199.

The Sixth Circuit reached a similar result in *Adams* v. *Standard Knitting Mills, Inc.*, 623 F.2d 422 (6th Cir. 1980), *cert. den.* 449 U.S. 1067 (1980). The Court found that the accounting firm of Peat, Marwick, Mitchell & Company had, in its preparation of audited Financial Statements, acted negligently [*id.* at 426-428]. However, the Court did not find that a negligent audit could, standing alone, give rise to an inference of *scienter* and accordingly dismissed the Complaint.

In the instant case, the Court of Appeals holding that an accountant may be inferred to have acted with fraudulent intent based merely on the performance of certain auditing tests manifestly conflicted with this Court's holding in *Ernst & Ernst*, and the Third and Sixth Circuits' holdings in *McLean* and *Adams*.

CONCLUSION

For the foregoing reasons, the Petition of Louis Sternbach & Company for a Writ of Certiorari should be granted in all respects.

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